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## Strong Jobs Numbers Confirm Robust Expansion – Focus Turns to Rates and Policies

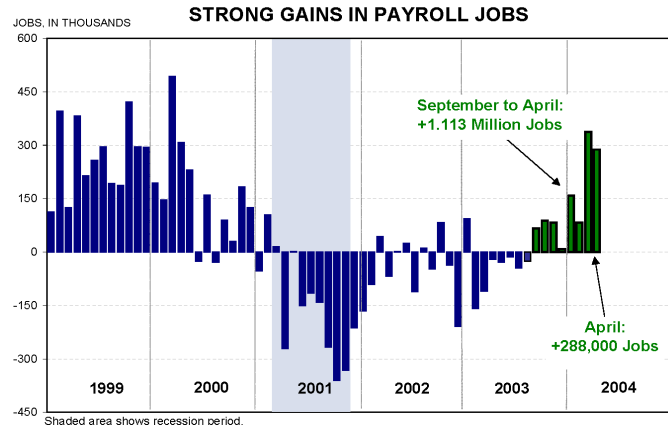
The strong employment report for April verifies an improved outlook for payroll jobs growth and the robust nature of the economic expansion. Payroll employment has now increased by more than 1.1 million jobs since last August, topping off a range of indicators showing very strong economic activity – with many at or near record high levels. The manufacturing sector has shown a notable turnaround, with activity indexes at their highest levels in 20 years and manufacturing payroll jobs rising over the past 3 months – the first manufacturing jobs gains since 2000.

Analysts expect continued strong economic growth through 2005, with gradual increases in interest rates and inflation. With this growth momentum in place, analysts have shifted their focus to other issues, such as: oil and gasoline prices; inflation; the value of the dollar; long-term interest rates and stock market valuations; fiscal policy effects; and the outlook for Federal Reserve policy.

### Recent Data

Employment and other measures show a strong expansion.

- **Employment Situation:** Payroll employment rose by 288,000 jobs in April, and the unemployment rate fell to 5.6 percent (down from 6.3 percent last June). In addition, jobs gains in prior months were revised upward, with March now showing an increase of 337,000 (up from 308,000). These figures brought the total increase since August 2003 to 1.1 million jobs. Manufacturing employment increased by 21,000 jobs in April, and February and March levels were revised up to show jobs gains as well – the first increases in 4 years. Every major sector of the economy showed jobs gains. In addition, new claims for unemployment insurance recently fell to their lowest level in 3½ years, bolstering the outlook for further jobs gains.
- **Gross Domestic Product [GDP]:** Real GDP grew at a 4.2-percent annual rate in the first quarter – following growth of 4.1 percent in the fourth quarter of 2003, and



8.2 percent in the third quarter. Real GDP growth over the past 3 quarters was the highest rate in two decades.

- **Manufacturing:** According to the Institute for Supply Management, manufacturing activity increased in April (the 11th consecutive month of growth), and recently has been at its highest levels in 20 years. Manufacturing industrial production has increased at a 5.2-percent annual rate since May 2003 – the best performance in nearly 4 years. New orders and shipments of manufacturers' durable goods have been on strong upward trends over the past year, surging further in recent months.
- **Nonmanufacturing Activity:** Nonmanufacturing business activity increased to a record-high level in April. All components of the index showed strong, expanding activity: new orders, employment, supplier deliveries, inventories, prices, backlog of orders, new export orders, imports, and inventory sentiment.
- **Housing Markets:** Housing starts have been running at their highest levels in 20 years – at a pace of more than 2 million new housing units per year. Sales of new single-family houses hit a record high in March, at a 1.228-million annual rate.

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## Other Issues

As noted, with the strong jobs numbers confirming the robust expansion, analysts have begun to turn their focus to other factors, many of which result from the pressures exerted by a stronger economy – not necessarily because of any inherent weaknesses.

- **Crude Oil and Gasoline Prices:** The price of crude oil has increased to its highest levels in 24 years – near \$40 per barrel. In turn, the U.S. average retail price for regular gasoline rose to \$1.94 per gallon in the second week of May – a record high – up from \$1.49 a year ago. (In real, inflation-adjusted terms, gasoline prices peaked in early 1981 at about \$2.80 per gallon in today's prices). Higher energy and gasoline prices could create some drag on household spending.
- **Inflation:** The strong economy and higher energy prices, along with recent increases in core inflation (excluding food and energy), have raised concerns of higher future inflation. In March, core consumer price index [CPI] inflation was up 1.6 percent over the prior 12 months, compared with a 1.0-percent rate at the end of last year. The core CPI rose 2.9 percent at an annual rate for the 3 months ending in March.
- **Exchange Value of the Dollar:** The dollar's value has increased in recent weeks, rising 9 percent relative to the Yen and 4 percent relative to the Euro. These gains follow large declines of more than 30 percent relative to the Euro and more than 20 percent relative to the Yen over the prior 2 years. A rising value of the dollar might temper competitive price advantages that U.S. exporters gained when the dollar fell.
- **Fiscal Policy Effects:** Although the reduced tax burdens will be good for the economy, the large, initial benefits of recent years' tax relief bills will dissipate this year. Larger tax refunds in 2004 are not expected to recur in 2005, and the bonus depreciation tax incentives for

corporate equipment and software spending will be eliminated at the end of this year.

- **Long-Term Interest Rates and Stock Market:** The 10-year Treasury note yield increased sharply over the past 2 months, rising to 4.8 percent from about 3.7 percent in mid-March. Similarly, mortgage rates (30-year fixed) have increased from 5.4 percent to more than 6 percent. The increases in long-term rates have coincided with a slip back in the stock market – the Dow-Jones industrial average has declined about 6 percent in recent weeks.

## Economic Outlook and Fed Policy

The Blue Chip forecast projects relatively strong real GDP growth continuing through the end of next year – in the range of 3½ percent to 4½ percent at an annual rate (see table). The unemployment rate is expected to decline to 5.2 percent by the end of 2005, and interest rates are expected to gradually increase. CPI inflation is expected to slow initially, but then rise gradually through next year.

Blue Chip Economic Outlook, May 2004

	2003.4	2004.1	2004.2	2004.3	2004.4	2005.1	2005.2	2005.3	2005.4
	---- Actual ----		----- Projection -----						
Real GDP Growth	4.1	4.2	4.4	4.2	4.0	3.6	3.6	3.6	3.5
Unemployment Rate	5.9	5.6	5.6	5.5	5.4	5.4	5.3	5.3	5.2
CPI Inflation	0.7	3.5	2.5	1.9	2.0	2.2	2.2	2.3	2.3
3-month Treasury Bill	0.9	0.9	1.0	1.2	1.5	1.9	2.2	2.6	3.0
10-year Treasury Note	4.3	4.0	4.4	4.6	4.8	5.0	5.2	5.3	5.4

Private analysts expect that the Federal Reserve soon will begin raising short-term interest rates. Following its May 4 policy meeting, the Fed's Federal Open Market Committee acknowledged in its policy statement that the risks to sustainable growth and price stability were balanced and that "policy accommodation can be removed at a pace that is likely to be measured." Ninety-four percent of the Blue Chip forecasters expect a rate increase before the end of this year, with the consensus expecting an increase in the Federal funds rate from 1.0 percent to 1.6 percent by the end of this year, and 3.1 percent by the end of 2005.

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